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*State of New Mexico*  
**LEGISLATIVE FINANCE COMMITTEE**

325 Don Gaspar, Suite 101 • Santa Fe, NM 87501  
Phone: (505) 986-4550 • Fax: (505) 986-4545

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June 14, 2011

**MEMORANDUM**

TO: Senator John Arthur Smith, Chairman and LFC Members

FROM: Charles Kasscieh, Economist

**SUBJECT: LFC Report of Investment Performance – FY11 Third Quarter**

**INVESTMENT PERFORMANCE HIGHLIGHTS:**

- Percentage gains are slowing as the bull market loses steam. Including investment returns, contributions and distributions, the state's aggregate fund value gained \$1.2 billion for the quarter and over \$3.6 billion for the 12 months ending March 31. As of March 31, total fund value stands at \$36.3 billion.
- All funds achieved quarter and one-year results above the 60 percent equity/40 percent fixed income indices of 11.8%. Relatively high allocations to domestic equity market continue to reward the permanent funds, although the Land Grant Permanent Fund (LGPF) underperformed its internal benchmark, again by 50 basis points<sup>1</sup>.
- This apparent underperformance might be misleading, as the internal benchmark reflects a very high allocation to domestic equity, an asset class that has done particularly well. The current target does not reflect SIC's intent to reduce the policy allocation to domestic equities. Thus, until the policy target has been officially adjusted, any comparison to the policy index return will be over-stated.
- All asset classes for all funds were positive except for a slight negative return for economically targeted investments (ETIs) in the Severance Tax Permanent Fund (STPF). Best active management for SIC included private equity and credit strategies as they recover value.
- PERA's managers contributed most notably in small-mid cap domestic equity, fixed income and hedge funds. Once again, PERA's portable alpha program boosted PERA's return by a significant amount.

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<sup>1</sup> One basis point equals 0.01 percent.

- For the first time in several quarters, ERB's managers did not add value net of fees, with only real asset and fixed income managers adding material value. However, ERB remains the only fund to beat both the 60/40 index and internal benchmarks for the quarter, one-year and five-year periods.
- Peer rankings were mixed, with ERB slipping in its longer standings due to its lower allocation to equities than peers during this bull market. ERB and PERA funds fell in the bottom half of their respective peer groups for the one-year period. PERA moved from the 95<sup>th</sup> percentile for the five-year comparison reported last quarter to 99<sup>th</sup>.
- Both permanent funds ranked in the top decile for the second consecutive quarter and in the top half of their respective peer groups for the one-year period. Their five-year standings have improved since the second quarter.

## FUND ASSET VALUES

Although losing steam from the double digit returns that marked the beginning of the fiscal year, third quarter gains continued to help restore fund balances devastated by the 2008-2009 market collapse. Aggregate fund value totals \$36.3 billion as of March 31, 2011, up \$3.6 billion from a year ago, or 11 percent. Including contributions and distributions as well as investment returns, ERB saw an increase of \$263 million, compared with \$400 million for the quarter ending December and \$625 million for the first quarter of FY11. With these gains, ERB is closing in on its September 2007 high of \$9.6 billion. PERA, increasing its total assets by just over \$400 million, is also inching its way toward its high of \$13.5 billion. The SIC funds (Land Grant Permanent Fund and Severance Tax Permanent Fund) distributed \$763 million during the 12-month period, primarily to New Mexico's educational institutions. Even with this cash outflow, favorable market conditions have added \$1.3 billion to the permanent funds over the same period.

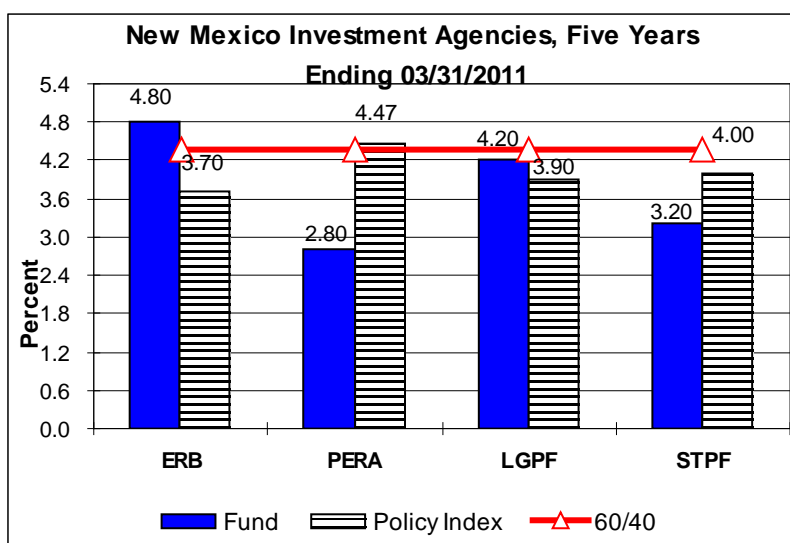
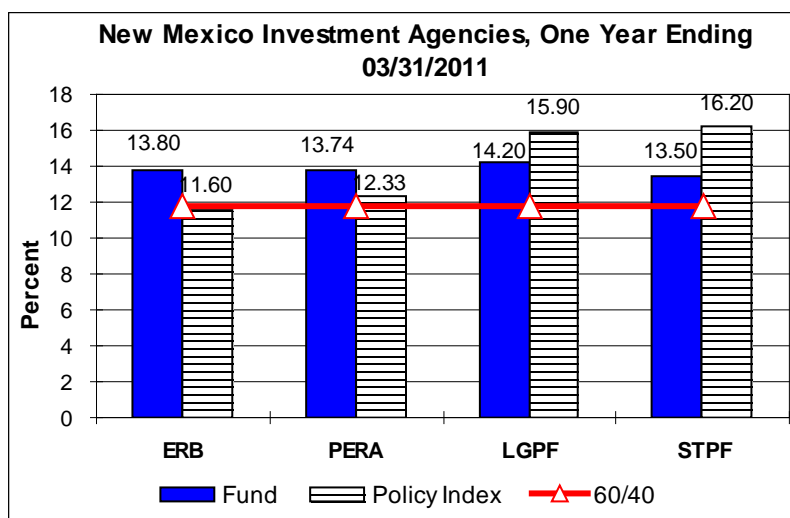
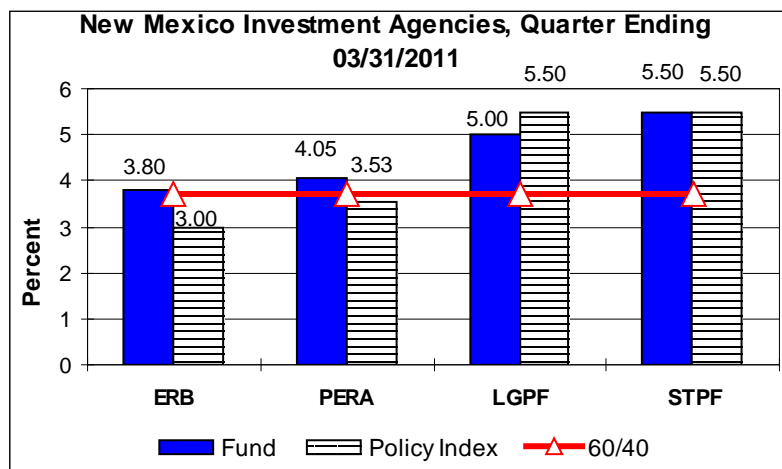
Current Asset Values\* (millions)  
For Quarter and Year Ending March 31, 2011

	ERB	PERA	LGPF	STPF	TOTAL
Current Asset Value	\$9,466	\$12,190	\$10,682	\$3,952	\$36,291
Value Change - Quarter	\$263	\$404	\$470	\$155	\$1,292
Percent Change - Quarter	2.9%	3.4%	4.6%	4.1%	3.7%
Value Change - Year	\$913	\$1,243	\$1,186	\$283	\$3,624
Percent Change - Year	10.7%	11.4%	12.5%	7.7%	11.1%

\*Changes include investment returns, contributions and distributions.

## PERFORMANCE SUMMARY

Quarter returns for all funds ranged from 3.8 percent for ERB to the high of 5.5 percent for the STPF. For both the quarter and for the year, all funds beat the 60/40 index, a hypothetical portfolio of 60 percent stocks and 40 percent fixed income that represents a passive, traditional asset portfolio. Produced during more normal market conditions, these results continue to support the state's diversification into alternative asset classes initiated in 2005 by the enactment of the Prudent Investor Act. However, all funds except ERB suffer compared to the 60/40 index for the five-year period, which included the 2008-2009 market collapse that rewarded funds holding high allocations in U.S. Treasuries. Significant contribution from a tactical allocation to credit strategies in the last quarter of FY09 lifts ERB's five-year return.



**Performance vs. Internal Benchmarks.** Comparing each fund to its internal benchmark yields additional insight into how well the agencies are managing the funds. Whereas the SIC funds posted the highest gains, the LGPF fell 50 bps below its benchmark for the second consecutive quarter. Both continue to lag behind policy indices for the year by 170 bps and 270 bps, respectively. This apparent underperformance might be overstated, as the internal benchmark reflects a very high allocation to domestic equity, an asset class that has done particularly well. However, SIC intends to reduce exposure to this asset class, as most institutional funds have done, in response to the exceptional volatility experienced during the market turmoil of 2008-2009. Until the policy target has been officially adjusted to reflect this intent, the policy index return will be over-stated. ERB continues to be the only fund to demonstrate consistent outperformance over all three time periods.

Economically targeted investments (ETIs) remain a drag on STPF investment performance, representing the primary difference between longer term LGPF and STPF results. Comparing fund returns with and without ETIs reveals this program has cost the STPF 50 bps for the last 10 years, returning only 0.8 percent over this period. The economic value added has not been determined.

## PERFORMANCE RELATIVE TO PEERS

Comparing performance to peers can shed insight into how policy decisions impact short and long term results. Consistent underperformance relative to peers suggests a failure to execute modern portfolio management effectively as well as the inability to hire good managers. This quarter produces a mixed bag of peer rankings that shows ERB slipping in the one- and five-year rankings but improving from the 56<sup>th</sup> percentile to the 45<sup>th</sup> percentile for the 10-year measure. PERA, LGPF and STPF also improved in the 10-year comparison, but PERA funds fell into the bottom half of peer groups for the one-year period. The permanent funds maintained their high quarterly rankings with the STPF improving from the 10<sup>th</sup> to the 6<sup>th</sup> percentile and the LGPF remaining at the 10<sup>th</sup> percentile for the second consecutive quarter. PERA remains stuck in the bottom 10 percent for the five-year comparison, still unable to overcome impacts from poor past manager underperformance that contributed to the fund's decline of \$4.2 billion during FY08-FY09.

**Peer Percentile Rankings\***

	<b>QTR</b>	<b>1 Year</b>	<b>5 Year</b>	<b>10 Year</b>
<b>ERB</b>	67	53	24	45
<b>PERA</b>	37	52	99	80
<b>LGPF</b>	10	17	60	68
<b>STPF</b>	6	26	73	79

\* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds.  
Permanent Funds ranked relative to U.S. Endowment Funds.

## ACTUAL VS. TARGET ASSET ALLOCATIONS

The target asset allocations shown below represent each fund's plan structure. Attachment A provides detail on how each asset class contributed to the funds' overall return as well as compared to benchmarks. During this year of the U.S. bull market, ERB's and PERA's overweight to domestic equities and SIC funds' underweight to their equity targets help explain a great deal of the individual fund performance relative to internal fund benchmarks, with the pension plans outperforming and the permanent funds underperforming for the quarter and one-year periods.

**Fund Asset Allocation Detail, Quarter Ending March 31, 2011**

	ERB*		PERA*		LGPF*		STPF*	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	28.8%	25.0%	29.2%	27.0%	44.0%	51.0%	38.5%	48.0%
International Equity	17.0%	20.0%	27.4%	27.0%	14.4%	10.0%	16.1%	10.0%
Fixed Income	30.4%	33.0%	23.7%	26.0%	18.4%	15.0%	16.2%	11.0%
Total Alternatives	16.9%	17.0%	18.8%	20.0%	18.8%	24.0%	20.9%	31.0%
Private Equity	3.9%	2.0%	2.9%	3.5%	9.0%	6.0%	11.9%	12.0%
Real Estate/Real Assets	6.0%	5.0%	6.6%	6.0%	3.5%	3.0%	4.6%	3.0%
Absolute Return	7.0%	10.0%	9.3%	10.5%	6.3%	15.0%	4.4%	15.0%
Other								
Global Asset Allocation	5.3%	5.0%						
ETI***							7.6%	1.0%
Cash Equivalents	1.4%	0.0%	0.5%	0.0%	4.4%	0.0%	0.6%	0.0%
Total Fund %	100%	100%	100%	100%	100%	100%	100%	100%

\*All funds are reducing exposure to equities and increasing other asset allocations.

\*\*Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.

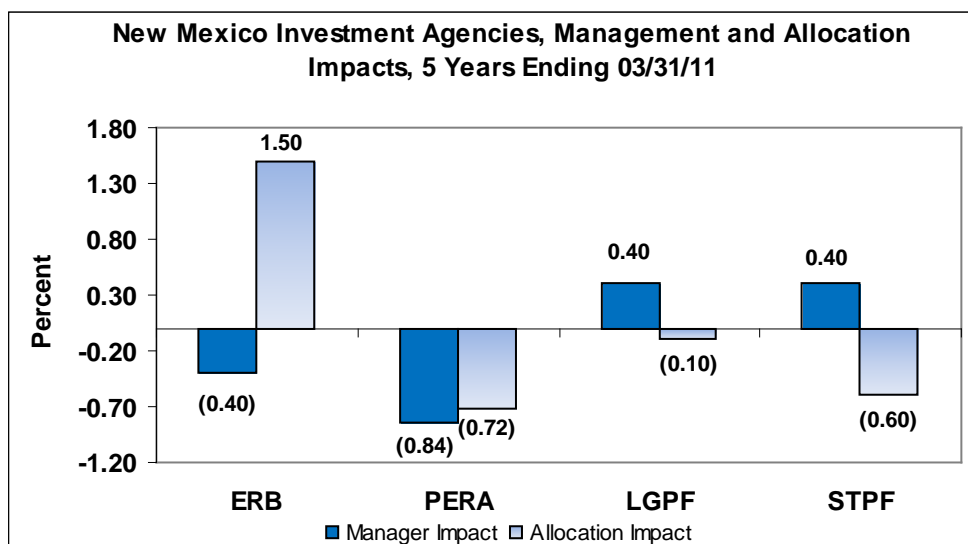
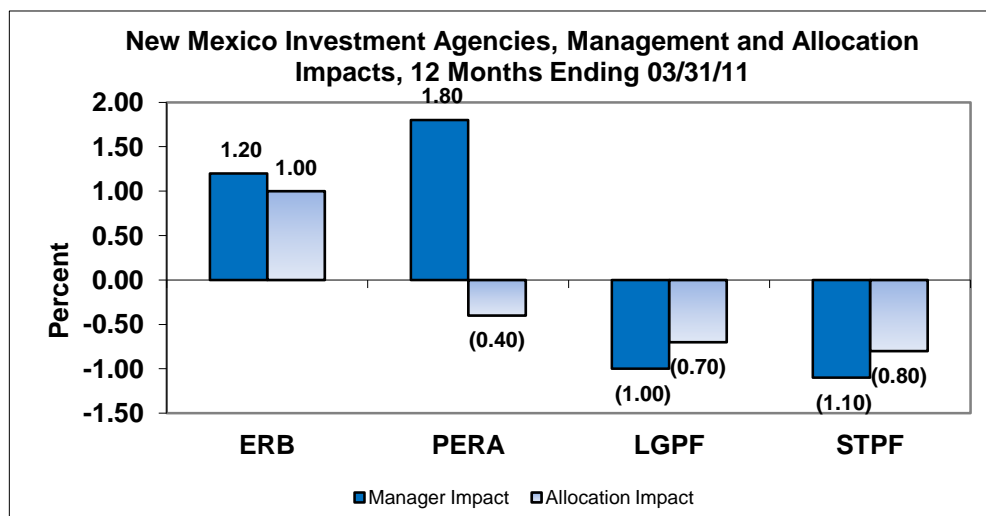
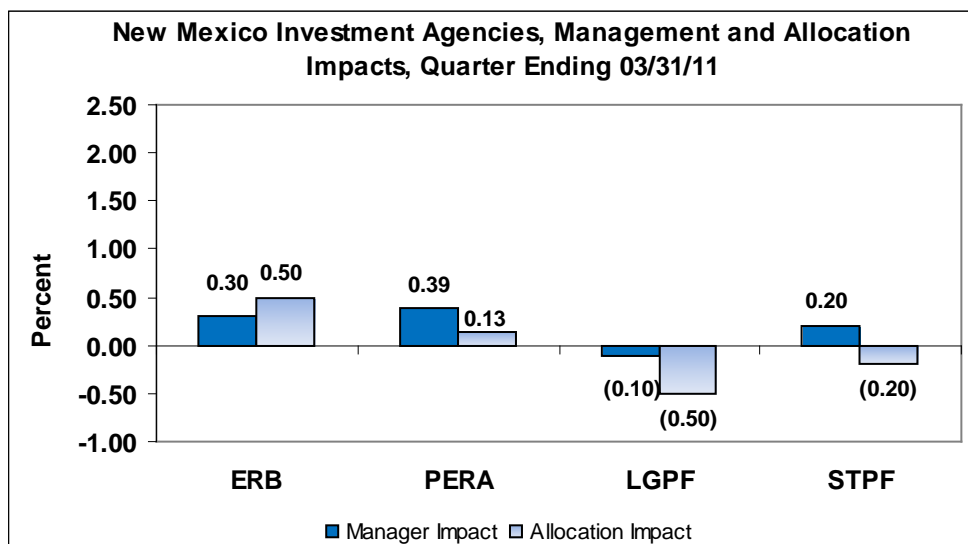
\*\*\*ETI: Economically targeted investments include state private equity.

## ATTRIBUTION ANALYSIS

Performance relative to fund benchmarks can be further broken down into specific contributors to results.

**Policy Impact.** How plan structure, or asset allocation, impacts performance can be measured by comparing the fund's policy index to the median fund's performance. ERB's lower allocation to equities continues to detract from performance, contributing to the fund's negative policy impact of 120 basis points (bps) for the quarter and 240 bps for the year ending March 31. As would be expected, SIC funds' higher relative allocation to domestic equities during this bullish run helped add 220 bps of performance to the LGPF for the quarter and 360 bps for the year.

**Active Management Impact.** Indexed assets will move as the market moves while active management is aimed at producing a higher return based on the manager's skill at taking advantage of market inefficiencies. Overall, active management was muted for the quarter but remains strong for the pension plans' 12-month period. Lackluster active management in some asset classes continues to plague SIC, although the agency notes that it has been firing underperforming managers since April 2010.



The portable alpha program once again boosted PERA's equity return, adding about 240 bps.<sup>2</sup> PERA notes that among fixed income managers, Western Asset was the strongest performer. Liquidation of Artio International Equity II is in process due to the underperformance to its benchmark on a three-year rolling basis and consistently ranking in the bottom third of its peer universe. For the first time in several quarters, overall active management for ERB failed to add much value for the quarter. In general, ERB's domestic equity managers fell short of the Russell 3000 benchmark by 50 bps, led by a negative 210 bps of underperformance by U.S. small cap managers. Wells Capital turned in an abysmal performance of -530 bps below its benchmark, net of fees. Offsetting this poor performance for domestic equity, managers for real assets (timber and infrastructure) added value, and credit strategy managers Beachpoint and Golden Tree continued their star performance, adding a combined 170 bps over the benchmark. SIC real estate holdings in Courtland continued to underperform, trailing its benchmark by 260 bps. However, SIC private equity managers were among the best performers. Attachment A provides additional detail on how active management for each asset category either added or detracted value by comparing results to respective benchmarks.

**Allocation Impact.** Allocation impact reflects how deviating from the target asset allocations either adds or detracts from performance. Deviations can occur due to market conditions moving the asset value—which may trigger rebalancing the class to within the targeted range—or through tactical decisions made by the boards. As discussed, much of the allocation impact for the quarter and trailing 12 months is explained by over- and under-over-weighting domestic equities. This detractor for SIC is slightly offset by the fixed income allocation impact of 20 bps for the year, the only positive impact for the portfolio. ERB's reporting of allocation impact is particularly robust. PERA's quarterly over-performance of 121 bps for domestic equities was undercut by a -76 bps allocation impact associated with underweighting fixed income. PERA started taking a more defensive position in this asset class with expectations of a rise in inflation, which has yet to materialize in any material fashion. On its part, ERB's defensive position reflects a desire to diversify portfolio risk and minimize return volatility by reducing exposure to equities.

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<sup>2</sup> Portable alpha means to invest in strategies that have little or no correlation between market movements and the portfolio.

## LONG TERM PERFORMANCE SUMMARY

Despite strong investment gains for FY10 and so far for FY11, longer term returns remain below the targets of 8 percent for the pension plans and 8.5 percent for the permanent funds needed to fund obligations. SIC plans to review their target returns to determine if a lower target is more appropriate.

### Fund Performance vs. Benchmarks

#### Educational Retirement Board (ERB)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
13.80%	11.60%	53	4.80%	3.70%	24	5.80%	5.50%	45
Median Fund Performance 14.00%			Median Fund Performance 4.30%			Median Fund Performance 5.80%		

\*ERB also has an 8% actuarial benchmark for funding purposes.

#### Public Employees Retirement Association (PERA)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
13.74%	12.33%	52	2.80%	4.47%	99	5.63%	5.60%	80
Median Fund Performance 13.93%			Median Fund Performance 4.47%			Median Fund Performance 6.22%		

\*PERA also has a long-term 8% actuarial benchmark for funding purposes.

#### Land Grant Permanent Fund (LGPf)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
14.20%	15.90%	17	4.20%	3.90%	60	5.40%	5.20%	68
Median Fund Performance 12.40%			Median Fund Performance 4.50%			Median Fund Performance 6.20%		

#### Severance Tax Permanent Fund (STPF)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
13.50%	16.20%	26	3.20%	4.00%	73	4.60%	5.30%	79
Median Fund Performance 12.40%			Median Fund Performance 4.50%			Median Fund Performance 6.20%		